The Central Provident Fund : Challenges Ahead

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SUMMARY

This report provides background on the Central Provident Fund (CPF), a mandatory savings scheme for Singapore citizens and permanent residents, and discusses challenges Singapore faces in providing for the retirement needs of its population. Introduced in 1955, the CPF has 3.0 million members with a total of S$96.4 billion (US$55.5 billion) in accounts as of December 31, 2002. From a mere social security scheme, the CPF has evolved into a vehicle for financing home ownership, medical care, education and investments. Currently, members' CPF balances are divided into three accounts: the Ordinary Account (for housing, approved investments, CPF insurance, tertiary education and topping-up of parents' Retirement Accounts); a Special Account (for old age, contingencies, approved investments, CPF insurance), and a Medisave Account (for hospitalization expenses, approved outpatient treatments and approved medical insurance premiums). There are mandatory contribution rates for the individual accounts. Currently, employees contribute 20% of their income to their own accounts, and employers contribute another 16%. The Government uses the contribution rates as a counter-cyclical economic policy tool.

The Singapore government in 1986 moved to give account holders new investment options, including privately-managed investment products approved by the CPF Board. Account holders still have the option earning standard CPF interest rates. These steps culminated in 1997 with the CPF Investment Scheme (CPFIS). The CPF website shows that as of end-Sep 2002 (latest available), about 700,000 CPF members have invested more than S$44 billion (US$25 billion) in various investments approved by the CPF Board; however, most investments offered under CPFIS bear substantial fees and costs, which eat substantially into returns. In 2001, the Government created the IRA-like Supplementary Retirement Scheme (SRS) as a further option for savings. The liberalization of investments of CPF savings and the introduction of the SRS are also seen as avenues to promote the fund management industry in Singapore.

Despite the country's high savings rate, many average Singaporeans may, paradoxically, be unprepared financially for retirement, because of low CPF returns, withdrawals for non-retirement purposes (like housing and education), and an over-concentration of members' CPF balances in real estate. In July 2002, a Government committee bluntly stated that "the current rates of return on CPF balances are not adequate for retirement funds with a long-term horizon," and that returns on CPF savings are "significantly lower than pension funds in most countries". These problems are exacerbated by Singapore's aging demographics. The Government subsequently announced selective changes to the CPF system. To address the over-investment of assets in housing, the government has reduced the CPF housing loan cap from 150% to 120% of the property value. At the same time, the government announced plans for a framework of privately-managed pension funds to be offered to CPF members. Officials also lowered the employees' contribution rate for workers aged 50-55 from the present level of 20% to 16%, asserting this will make such workers more employable.

Some critics say the changes do not go far enough. They continue to contend that the CPF has become too far removed from its original role as a long-term social security fund, and should be pruned back to that original role, with housing, medical care, education financing addressed through other products or at least channeled through stand-alone accounts (as was done with the Medisave account). For example, while making changes to trim over-investment in real estate, the government introduced other changes that encourage such investments. The latest changes are unlikely to improve the retirement funds of members in the short term, according to most analysts. More fundamental – but politically difficult – changes may be needed to prevent a retirement funding crisis in the longer term.

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BACKGROUND ON CPF

The Central Provident Fund (CPF) has been the government's main vehicle to provide for the essential needs (housing, medical care, retirement) of Singapore citizens and permanent residents, and a key tool in mobilizing a ready pool of capital for public investment purposes. The CPF was originally set up by Singapore's British colonial government in 1955 as a mandatory savings plan for old age. While the CPF has gone through many changes, it remains a mandatory, fully-funded scheme based on asset accumulation by its members through individual accounts. As a fully-funded system, the payout for members in retirement – or how much they can withdraw for other purposes at an earlier time – is limited to the savings (plus interest or dividends) members have set aside. There is therefore no cross-generation subsidy, mitigating the possibility of future unfunded liabilities. As of September 30, 2002 the CPF had 3.0 million account holders, with total savings of S$95.4 billion (US$53.7 billion).

The CPF Board invests its funds in bank deposits, properties and other authorized investments to generate earnings. Income is paid to CPF members as interest, with the rate determined quarterly based on market conditions. A summary of CPF contributions and withdrawals, and the Board's income is tabled in the Annex.

Contribution Rates

The CPF Act establishes mandatory contribution rates for the individual accounts. The CPF began in 1955 with employees contributing 5% of their income to their own accounts, and employers contributing another 5%. The contribution rate increased over the years to a high of 25% in 1985, with equal contribution rates for employers and employees. In 1986, in response to a sharp recession, the government temporarily cut the employers' contribution rate to 10% but kept the employees' share at 25%. The purpose was to help businesses cut labor costs, and thereby minimize job losses. As a permanent measure, the government also re-structured the contribution rates by age groups with lower rates for older workers. Employer-employee contribution rates were gradually equalized again in the late 1980s and early 1990s.

During the 1997-1998 Asian economic crisis, the rate for employers (for the 55 years & below category) was again cut, this time to 10%. It was restored after the crisis to 16%. Plans to reinstate the balance of four percentage points have been repeatedly postponed because of unfavorable economic conditions. Most recently, the government announced in February 2003 that the restoration has been postponed until 2005. The rates as of January 1, 2003 are as follows:

Table: CPF Contribution Rates (%) - Employers:Employees

Age Group	1988	1994-1998	2001
55 years & below	12:24	20:20	20:16
Above 55-60 years	11:20	75:12.5	6.5:12.5
Above 60-65 years	9:19	7.5:7.5	3.5:7.5
Above 65 years	8:18	5:5	3.5:5.0

To steer the wage system away from a seniority-based to a flexible wage system, the government in 2002 moved to fix permanently the employers' CPF contribution rate for workers in the 50-55 age group at its present 16%, and to lower the employees' contribution rate in this age group from 20% to 16%. The change is intended to make older workers more attractive to employers, especially given increased structural unemployment. The Government also raised the minimum salary for employer contributions, although it reduced the maximum overall salary for CPF contributions.

Structure of CPF Account

Currently, members' CPF balances are divided into three accounts:

- Ordinary Account (for housing, approved investments, CPF insurance, tertiary education and topping-up of parents' Retirement Accounts). The interest rate for the Ordinary Account is calculated as an average of the 12-month deposit and month-end savings rates of Singapore's major banks, subject to a minimum nominal rate of 2.5%/annum.

- Special Account (for old age, contingencies, approved investments, CPF insurance). As of end-December 2002, the interest rate for the Special Account was 4%/annum.

- Medisave Account (for hospitalization expenses, Hepatitis B vaccinations, chemotherapy, radiotherapy, approved outpatient treatments and approved medical insurance premiums). As of end-December 2002, the interest rate for the Medisave Account was 4%/annum.

In addition, at age 55, members must start a Retirement Account and set aside a minimum sum of S$75,000 (about US$42,000) for withdrawals by installments at the age of 62. Effective July 1, 2003 the minimum sum will be increased to S$80,000 (US$45,000).

Table: Contributions Rates (%) to the CPF Sub-Accounts*

Age Group	Total	Ordinary	Special	Medisave
Below 35	36	26	4 (5)	6 (7)
35-44	36	23	6 (7)	7 (8)
45-55	36	22	6 (9)	8 (9)
56-60	18.5	10.5	0	8 (9)
61-65	11	2.5	0	8.5 (9)
Above 65	8.5	0	0	8.5 (9)

** As of 1 January 2001; different rates apply for certain new Singapore permanent residents.*
() Figures in parenthesis will be effective if/when contribution rate is restored to 40%.

In July 2002, the Government announced plans to increase the contribution rate to the Special Account by one percentage point for members age 55 years and below, and while the rate to the Medisave Account by one percentage point for members age 60 and below, and by 0.5%-point for members age 61 and above. These higher contribution rates will be matched by corresponding reductions in contributions to the Ordinary Account. The increases will be effective when the total CPF contribution rate is restored to 40% for those workers age 55 and below. These changes are meant to raise the retirement and healthcare savings levels of CPF members as, presently, only half of CPF members, at age 55, have S$55,000 in their Special Accounts.

EVOLUTION OF THE CPF BEYOND OLD-AGE SOCIAL SECURITY

In the early years, the CPF adhered strictly to its original objective of providing for old age. However, over time the CPF evolved such that savings meant for retirement could be used for other needs. The first step in this evolution came in 1968, when the Public Housing Scheme enabled members to pay for subsidized public housing built by the Housing & Development Board (HDB). Facilitating home ownership remains a key Government goal for the CPF; in July 2002, Singapore's Minister for National Development reiterated that there will be no change to the government's commitment to provide basic housing through subsidized HDB apartments.

The CPF Board provided additional add-ons in the early 1980s with the aim of helping Singaporeans meet other basic needs. These additions include a "Residential Properties Scheme" to allow members to buy private homes for investment (1981); a "Home Protection Scheme" to protect CPF members against losing their homes in cases of death or permanent disability (1982); and the "Medisave scheme" to help members meet hospitalization expenses (1984).

While providing for medical care in old age is accepted as an integral part of the CPF, many observers question the huge withdrawals of CPF savings for housing needs. As of December 30, 2001, CPF statistics (latest available) showed that S$57 billion had been withdrawn for public housing and S$33 billion for private housing since the inception of the housing schemes. The government moved in July 2002 to reduce the cap for CPF withdrawals for non-subsidized housing loans from 150% to 120% of the property value; officials said the action was intended to redress the over-concentration of members' CPF balances in real estate. However, the effect may have been undercut by a nearly simultaneous move to allow CPF savings to be used to pay half of the 20% downpayment requirement for the purchase of new residential property. Some analysts charged that the government could not resist using the CPF as a tool for boosting the sluggish property market.

DEVELOPMENT OF CPF INVESTMENT SCHEME

By the early 1980s, criticism grew that the low interest rates on CPF accounts did not offer any protection against inflation or potential for growth. The CPF Board therefore created a succession of programs to allow members to buy approved equities, unit trusts, gold, and other instruments, initially culminating in 1997 with the CPF Investment Scheme (CPFIS). However, with surveys still showing that most Singaporeans were still inadequately prepared financially for old age, further refinements were made. Most importantly, in January 1, 2001, the Government increased the contribution rate for the Special Account and also allowed members under 55 to invest their Special Account savings in lower-risk financial instruments. With the liberalization of the Special Account, CPF members can invest all their savings from the Ordinary and Special Accounts into approved private-sector investment products. In July 2002, the government further relaxed investment rules by allowing CPF members to invest in foreign currency unit trusts and property trusts listed on the Singapore Exchange.

The rationale for the liberalization is to shift the onus of ensuring sufficient income for old age from the government to the CPF members themselves. Accepting recommendations for changes to the CPF made by a government/private sector review panel in 2002, officials noted that the middle 70% of the working population depend on CPF savings for retirement. The bottom 10% needs government assistance while the top 20% is capable of providing for their own retirement needs outside the CPF.

The Government has sought to create incentives for account holders to invest their funds in professionally managed products, by limiting direct investments in equities to no more than 35% of savings in the Ordinary and Special Accounts. This also served to stimulate the development of Singapore as a fund management center, a second key objective of the liberalization. However, CPF members can only invest in funds offered by approved investment advisors. As of end-December 2002, the CPF Board approved 33 fund management companies to offer investment products under the CPFIS. There are altogether 217 unit trusts and 159 investment-linked insurance products included under the CPFIS.

From the CPFIS' introduction in 1997 to end-September 2002, CPF members have channeled S$27.6 billion (US$15.5 billion) from their Ordinary and Special Accounts to investments under the CPFIS. Statistics show that CPF members prefer to invest in insurance-related products rather than unit trusts and other instruments. Investments in stocks have been gradually diverted to insurance-linked investments and unit trusts. As at September 30, 2002, S$13.0 billion (US$7.3 billion) is invested in investment-linked insurance products, compared to S$7.9 billion (US$4.4 billion) in stocks, and only S$2.4 billion (US$1.4 billion) in unit trusts. But there remains considerable room for growth: as of September 30, S$63 billion (US$35.5 billion) in funds that could be invested remained uninvested.

Table: Amount Invested under CPFIS as of September 30, 2001 and September 30, 2002

	As of September 2001	As of September 2002
Stocks/Loan Stocks	8,648	7,883
Insurance Products	13,719	16,422
Unit Trusts	2,106	3,081
Deposits	4	5
Others	248	180
Total Invested	24,725	27,571

Overall, the CPFIS liberalization has unlocked a substantial amount of savings for the fund management industry, from S$15 billion (US$8.8 billion) as of end-September, 1999 to S$27.6 billion (US$15.5 billion) as of end-September, 2002. It has also motivated local banks and fund management companies to offer more products, resulting in the growth of the fund management industry.

CPFIS: Evaluating Performance

In 1999, the CPF Board appointed William M. Mercer Singapore as a consultant to assist it in evaluating products offered by the fund management companies. From July 2002, Standard & Poors (S&P) has replaced William M. Mercer to provide quarterly evaluations of the performance of insurance-linked investments and unit trusts under the CPFIS. Mercer continues to advise the CPF Board on the appointment of new fund managers/insurers and the inclusion of new products under the CPFIS. A Fund Performance Tracking Committee consisting of the Life Insurance Association of Singapore, the Investment Management Association of Singapore and the Securities Investors Association of Singapore, was set up in July 2002 to work with Standards & Poors to educate the public on fund investments.

S&P reviews every firm on every product every quarter, but may do a special review if there are personnel changes at a fund. To help CPF members select unit trusts under the CPFIS which best suit their needs and goals, the CPF Board with consultation from Mercer set up a risk classification system for the products listed by the approved fund management companies. The system classifies unit trusts into four broad groups by ascending degree of risks: lower risk; low to medium risk; medium to high risk; and higher risk. As of end-December 2002, the distribution of CPFIS-included investments in the four categories is as below:

Risk Classification	Unit Trusts	ILPs (*)
Higher Risk	135	77
Medium to High Risk	23	44
Low to Medium Risk	55	32
Lower Risk	4	6

(Insurance-linked products)*

Nearly S$4.6 billion (US$2.6 billion) of CPFIS funds were invested in higher-risk unit trusts and S$3.4 billion (US$1.9 billion) in higher-risk insurance-linked products (ILPs) as at end-December 2002. According to S&P's risk/return analysis over a three-year period, in the entire group of CPFIS-included unit trusts, 32% are funds which have above-average return but below-average risk, while 47% of the funds with below-average return but above-average risk. For the ILPs, 36% of the funds had above-average returns and above-average risk, while 49% had below-average returns but above-average risk. Investors appear willing to put their monies in new funds with no track record in hope of high returns. Observers have been advocating for the past few years that should be a wider choice of funds in the "medium-to-high risk" and "low-to-medium risk" categories to assist CPF investors in seeking better risk-adjusted returns.

S&P uses a fund rating system; funds must have a minimum three-year track record, and belong to a sector that contain five or more funds, all with a minimum investment history of three years as well. As of end-December 2002, the rating for CPFIS-included unit trusts and ILPs is as follows:

S&p Fund Stars	No. of Unit Trusts	No. of ILPs
Five stars	5	1
Four stars	20	5
Three stars	16	6
Two stars	17	5
One star	19	6

Overall, the public experience with CPFIS products has been very disappointing. Aside from declines in Singaporean and global equity markets (for the three years ended Dec. 31, 2002, only one in ten CPFIS-approved funds beat CPF's 2.5% ordinary yield), high fees and expense ratios on most CPFIS products have substantially eaten into returns, a problem exacerbated by the small size of many CPF-approved funds. A Government panel in July 2002 stated that "under the existing cost structure of CPFIS unit trust investments, an estimated 41% of the terminal value of invested funds is eroded by various investment costs by the time of retirement." The panel said this assumed members hold on to investments until retirement; if they switched investments, the amount lost to fees would be even higher.

To address this problem, the CPF Board is working with an investment consultant to plan and design a framework under which low-cost privately-managed pension funds would be offered to CPF members. Such a change could result in much lower fees. Even some local fund managers say that, if they had the choice of investment in a CPFIS-approved mutual fund or in a privately managed CPF pension fund, they would choose the later. No timetable has been outlined for the introduction of the new funds.

RETIREMENT SAVINGS AT CROSSROADS

While the introduction of a higher minimum sum for CPF accounts and the introduction of privately-managed pension plans under the CPF could give CPF members new options for growing their savings, they may not address the fundamental fact that most Singaporeans' existing CPF savings and investments may not be adequate for retirement. One analyst says average monthly balances in CPF savings provide an earned income replacement rate of only between 20-40%. Concerned with this, the Government in April 2001 instituted the Supplementary Retirement Scheme (SRS). The SRS supplements the CPF and CPFIS, and resembles the U.S. Individual Retirement Account (IRA). Employees who are Singaporeans or permanent residents can contribute up to 15% of their annual income to an SRS account, up to a maximum of S$72,000 (US$40,000), which can be invested in financial products approved by the MAS. Foreigners can contribute up to 25% of their income to an SRS account, but will only be allowed to withdraw the funds after ten years.

Unlike the CPF, only employees can contribute to the SRS. The withdrawal age for SRS savings is set at 62, and early withdrawals will be penalized at 5% of the amount withdrawn, with exceptions for death, permanent disability and bankruptcy. Only 50% of the savings in the SRS will be taxed, if withdrawn at retirement. Capital gains from SRS investments are tax-free, but gains from Singapore dividends are not tax-exempted.

Interest in the SRS has been slow to develop. The Ministry of Finance website showed that there were 16,548 SRS account holders with S$313 million (US$178 million) as of end-2002, double the total in 2001. This represents 0.4% of the total number of CPF account holders. The participation rate may go up with the new ceiling contribution of $5,000 as the CPF Board has encouraged affected employees to transfer their income to the SRS to avoid paying higher taxes. Any income paid to the CPF and SRS Accounts are tax-exempt. Critics charge that the scheme is targeted at the wrong group -- the affluent who pay higher tax rates, not the two-thirds of the population which are exempt from taxes and which are demographically the least prepared for retirement. They believe SRS could be more useful if it focused on the "average Singaporean," allowed employer contributions, and if there were a special benefit for tax-exempt Singaporeans, in lieu of a tax deduction.

LOOKING TOWARD THE FUTURE

The Singapore Government can be justifiably proud of the role played by the CPF in mobilizing savings and underpinning Singapore's high home-ownership rate. Yet despite the country's high savings rate, many average Singaporeans remain, paradoxically, generally unprepared financially for retirement, because of the low returns on CPF balances, the high-investment related costs and poor performance of most CPFIS investment products, withdrawals for non-retirement purposes (like housing and education), and the over-concentration of members' CPF balances in real estate. These problems are exacerbated by the sharp downturn in property prices since 1996 and by Singapore's aging demographics. In July 2002, a Government committee bluntly stated that "the current rates of return on CPF balances are not adequate for retirement funds with a long-term horizon," and that returns on CPF savings are "significantly lower than pension funds in most countries".

Merely increasing members' contribution rates – as the Government has done with respect to the Special Account – may be ineffective, assert some analysts. One researcher argues that basing Ordinary Account returns on short term-interest rates when the purpose of the funds is long-term is lacks economic rationale, unless the government is seeking to use CPF balances as a source of cheap funding for itself. He posits that in many years the real interest rate has been negative, while returns on CPF balances investment by the Government are presumed to have been positive.

Observers question whether the newly announced changes to the CPF structure are sufficient to address these challenges, although for their part, most Singaporeans are relieved that there are no radical changes to the CPF system. The changes that have been introduced are likely to impact middle-aged Singaporeans in the middle-income bracket, whose CPF savings will grow at a slower rate as a result of the four percentage point cut in employers' contribution and the new $5,000 ceiling cap. The change may be intended to make these workers more employable, but the policy shift may not address the underlying problems confronting the CPF.

Addressing the challenges outlined above is politically charged; any drastic shift by CPF away from non-retirement public policy goals would be hugely unpopular, and government officials stress they have no intention of any radical overhaul of the entitlements that have grown up around the CPF over time. The Government also continues to find the CPF a useful channel for pump-priming activity in times of economic difficulty. For example, it has made repeated direct contributions (i.e., "top-ups") to members' accounts through a series of special transfers since 1995. Whether the CPF is the most appropriate vehicle for such largesse remains an open question.

It is clear that officials agree that the system needs to be adjusted in order to provide a framework which allows CPF members to save enough for retirement while taking charge of their own CPF savings. Providing low-cost privately-managed pension plans to CPF members may help. But with a finite horizon for addressing the needs of a rapidly aging population, especially amid a more modest outlook for longer-term economic growth, some commentators assert that the time may have come to return CPF to its roots, while shifting other entitlements or public policy goals to separate, stand-alone programs.

ANNEX
CENTRAL PROVIDENT BOARD
SUMMARY OF CONTRIBUTIONS & WITHDRAWALS, INTEREST EARNED
(S$ millions)

	1998	1999	2000	2001	1Q 2002
Excess of Contributions Over Withdrawals (During Period)	2,371	15	-478	-567	750
Members' Contributions	16,000	12,827	14,093	18,322	4,660
Withdrawals	13,629	12,812	14,571	18,889	3,910
Approved Housing Schemes	7,835	9,528	8,655	8,263	2,164
Under Section 15	1,847	1,671	1,689	2,226	498
Medical Schemes	441	445	518	532	121
Others	3,507	1,168	3,718	7,869	1,127
Interest Credited to Members' Balances (During Period)	3,249	3,105	2,380	2,490	718
Advanced Deposits With MAS (During Period)	5,968	3,577	578	1,649	814
Interest Earnings From Investments (During Period)	3,480	3,310	2,538	2,662	756
Holdings of Government Securities (End Period)	59,620	62,620	60,620	89,410	91,327
Members' Balances (End Period)	85,277	88,397	90,298	92,221	93,689

(Exchange Rate as at 12/31/02): US$1=S$1.7365)